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ABSTRACT

This bulletin describes types of prepayment and savings plans for financing college education, outlines advantages and disadvantages of these programs, and highlights issues that state and institutional planners and policymakers should consider. A description of existing tuition prepayment plans looks at state plans that typically permit investors to pre-purchase tuition for their beneficiaries at any public institution tax-free, at a cost equal to or less than the current cost of tuition. Drawbacks to these plans include restricting students to institutions in their own state, and problems with tuition caps and increases, equity, and accessibility of such plans to low- and middle-income groups. A further section discusses college savings plans which utilize state and city college savings bonds and federal EE Series savings bonds. Half of the states currently issue college savings bonds; Chicago (Illinois) and Pittsburgh (Pennsylvania) are two cities offering college savings bonds. A review of combination guarantee and savings plans describes the Massachusetts College Opportunity Funds and the College Sure Certificate of Deposit. The report concludes that these plans can increase a family's resources in financing postsecondary education. No single plan is without drawbacks, however, and most provide little benefit to the financially disadvantaged. Includes two comparison tables and 12 references. (JB)

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The Risks and Rewards of College/ University Prepayment and Savings Plans

by
Mark Rothschild

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Fueled by escalating college costs (see table next page), reductions in federal grant assistance, and a general inability of middle-income families to save money, a variety of public- and private-sector programs have been established to help parents prepay their children's postsecondary education. These financing mechanisms typically fall into three categories: tuition prepayment plans, college savings plans, and combination guarantee and savings plans. While new college financing programs are rapidly emerging across the country, some seasoned programs are barely surviving and still others are folding completely, leaving parents and policymakers confused and doubtful about the utility of these plans. This bulletin describes each type of financing program, outlines its advantages and disadvantages, and highlights issues that state and institutional planners and policymakers should consider prior to implementing any college financing program.

Tuition Prepayment Plans

Tuition prepayment plans allow investors to purchase tuition contracts that guarantee payment of the future postsecondary education costs of a named beneficiary. These programs are offered at state-, institutional-, and private-sector levels.

State Tuition Prepayment Programs

State tuition prepayment programs typically permit investors to prepurchase tuition for their beneficiaries at any public institution within the participating state at a cost equal to or less than the current cost of tuition. Investors are not taxed on the interest while the money is invested by the state, parents may deduct the investment from their state taxable income, and beneficiaries are guaranteed full payment of their tuition when they matriculate.

As of October 1991, at least 13 states had adopted tuition prepayment plans, but only 5 (Alabama, Florida, Michigan, Ohio, and Wyoming) had programs in operation. Other states are now considering legislation to create prepayment programs.

There are many advantages to these state trust plans. Foremost among them is that students are guaranteed that their college tuition will be paid in full, regardless of how expensive higher education may become. Parents are reported to name this feature as the primary reason for investing in state prepayment programs. Other advantages to these plans include increased investment funds for the state and state-tax-free investments for parents. Further, the risks to individual investors, such as short-term market and economic fluctuations, are reduced because state prepayment fund managers are able to diversify their investments and take long-range investment perspectives (Anderson, 1987).

COST OF ATTENDANCE AND INCOME
1981-82 TO 1990-91

Current Dollars

	Cost of Attendance (per year)					Income	
	Private University	*Private Four-year College*	*Public University*	*Public Four-year College*	*Public Two-year College*	*Personal (Per Capita)*	*Median Family*
1981-82	7,443	5,947	3,079	2,704	2,223	9,240	22,388
1982-83	8,537	6,646	3,403	3,032	2,390	9,721	23,433
1983-84	9,307	7,244	3,628	3,285	2,534	10,350	24,674
1984-85	10,243	7,849	3,899	3,518	2,807	11,257	26,433
1985-86	11,034	8,551	4,146	3,637	2,981	11,863	27,735
1986-87	12,278	9,276	4,470	3,891	2,988	12,474	29,458
1987-88	13,074	9,854	4,618	4,250	3,066	13,081	30,970
1988-89	14,073	10,620	4,905	4,525	3,183	14,109	32,191
1989-90	15,165	11,423	5,289	4,757	3,325	14,973	34,213
1990-91	16,356	12,320	5,577	5,013	3,485	15,695	NA

Source: College Board (1991).

One drawback to state plans is that students may be restricted to attending schools within their state. In addition, colleges may face the dilemma of either accepting students who do not meet admissions criteria or rejecting them and alienating parents who already have paid for their children's education. All states offer refunds for unused tuition payments. There are penalties in most states, however, that result in limited or no earnings on the interest.

State prepaid tuition programs have other complications. The cost of participating in tuition prepayment plans is generally based on current and projected tuition levels within the state. Because the goal of the state is to maximize the real rate of return on the invested tuition funds, states will likely want to keep future tuition levels at or below the rate of inflation. As a result, such programs may *cap tuition levels* and tie tuition rates to external markets, which may not be in the best interest of the state (Hodel & Layzell, 1989). Because tuition increases normally outpace inflation, this could create a problem in balancing institutional financial need and program integrity.

On the other hand, *tuition hikes* rather than tuition caps can present problems. If tuition is increased to help cover program operating costs, those families unprotected by the guarantees may, in effect, be forced to subsidize these programs. The resulting tuition hikes may make college increasingly unattainable for low- and lower-middle-income groups.

Equity issues also arise in tuition prepayment programs. Regardless of how they are designed, tuition prepayment programs tie up a significant amount of a family's disposable income. Many prepayment programs may be well

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out of reach for low- and lower-middle-income families, who typically have limited disposable incomes. This leaves middle- and upper-middle-income families to participate—groups that would most likely save for college without these state-tax-free programs in place. Still, prepayment programs may stimulate and increase savings and reduce middle-income demand for financial aid.

Another equity concern is that these programs are best suited for traditional 18- to 24-year-old full-time students whose parents can invest for them while they are still young, even though nontraditional students—older, part-time—are becoming the "new majority" on the American college campus. Long-term prepayment programs may not benefit new-majority students, who often do not plan to attend college as far in advance as their younger, full-time counterparts. If statewide prepayment programs continue to grow, new-majority students may balk at the notion of subsidizing the education of an elite corps of guaranteed tuition beneficiaries.

Tuition prepayment programs have come under fire by the Internal Revenue Service (IRS). Specifically, the Michigan Educational Trust (MET) has been subject to a private letter ruling regarding its tax status.[1] Although the IRS ruling is MET-specific, it has had ripple effects on prepayment program plans in many states.

The IRS ruled that the excess of the fair market value of the educational services received over the amount paid for the tuition prepayment contract would be taxable income to the student. For example, if an investor paid $6,000 for the contract and the cost of tuition at the time the beneficiary matriculated was $9,000, the $3,000 difference would be taxable income to the student, prorated over the period of college attendance.

In addition, the IRS disagreed with MET representatives who argued that because MET is a public-benefit corporation of the state, the trust earnings should be considered earnings of a governmental body and not be subject to federal income taxation. The IRS concluded that since those persons who benefit from the trust earnings are limited to the tuition prepayment contract beneficiaries, exclusions from income for public-benefit corporations, which exist for public rather than private interests, do not apply.

To make matters worse, the U.S. Department of Education ruled that a MET contract should be considered a "student asset" and not a "family asset" when calculating students' eligibility for federal aid ("Students," 1990). This is important because federal formulas used to determine student financial need assume that, prior to receiving aid, students will contribute as much as 35% of their own assets toward college each year. Families, in contrast, are expected to contribute a much smaller percentage of their assets. Unfortunately, this ruling could easily push some students out of eligibility range for financial aid. [2]

There has also been some debate concerning the solvency of MET. If MET's investment returns fail to achieve anticipated levels, or if tuition contract prices have been set too low, the Trust could have difficulty meeting its contractual obligations. Jeffrey S. Lehman, assistant professor of law at the University of Michigan, maintains that MET's shaky tax and tuition assumptions may put it over $100 million in debt. Professor Lehman's analysis has been severely criticized, however, and former Michigan State Treasurer Robert A. Bowman disputes the insolvency warnings, claiming that they were politically motivated. A recent actuarial report produced by Coopers and Lybrand (1991) indicates that MET appears solvent, although there will be solvency uncertainty "until the Trust matures and a record of meaningful experience is developed" (p. 1).

Prepayment programs may stimulate and increase savings and reduce middle-income demand for financial aid.

Meanwhile, MET has installed a new governing board that has elected to put the program in moratorium until financial conditions change and the program becomes less of a risk to the state. This decision may be reversed if the IRS ruling that requires MET to pay income tax on its earnings is overturned. The state of Michigan and MET have sued the federal government over this issue, and a federal court hearing has been scheduled for early 1992. At the time of this publication, MET had enrolled approximately 55,000 students and held some $400 million in assets.[3]

There have been developments in prepayment programs in other states as well. Indiana officials dropped their plans for a state prepaid tuition program after concluding that

[1] MET allows parents to make payments to a state-managed fund and guarantees that their payments will cover full tuition at any Michigan public institution once the beneficiary has been admitted. Students who attend private or out-of-state institutions may receive an amount equal to the cost of tuition at a Michigan public institution.

[2] It is possible for a financial aid administrator to adjust this assessment rate for any financial aid program (other than the Pell Grant program) if the administrator considers the rate inappropriate. The authority for this "professional judgement" is found in Section 479A of the Higher Education Act of 1965, as amended.

[3] For a full discussion of the characteristics of the participants in the MET program, see Lyddon and Prince (1991).

college savings programs offered by the state and federal government are a better deal for everyone involved. The Indiana Baccalaureate Education System Trust (BEST) was created by the general assembly in 1987, but the program was never implemented because of questions concerning tax status and liability issues. The recent MET rulings contributed to the decision to shelve BEST, but the Trust's board members say they would be willing to implement the program if the IRS alters its interpretation. Further, the board has recommended that Indiana officials join forces with representatives from Michigan and other states to lobby for a change in the IRS ruling.

While private-sector plans can enable parents to choose among colleges across the nation, participants are gambling on the colleges themselves.

The Florida Prepaid College Program began its fourth year of operation in October 1991. Unlike other state plans, the Florida plan can cover dormitory fees in addition to tuition charges. The plan is also unique in that the tuition guarantees are backed by the full faith and credit of the state.

Beneficiaries of this plan may attend any of Florida's nine state universities or 28 state community colleges and have the option of transferring the value of the contract to over 30 participating private, not-for-profit postsecondary institutions. An investor, who need not be a relative of the beneficiary, can choose a four-year university plan, a two-year community college plan, or a two-year community college/two-year university plan. The program has three payment plans: one single payment option and two monthly installment options. In the first three enrollment periods of the Florida program (through January 11, 1991), 138,123 tuition and dormitory contracts were sold, bringing in approximately $539 million.[4]

While states are anxiously awaiting the results of the MET lawsuit, Ohio and Florida have submitted ruling requests to the IRS regarding their state trust plans. In addition, there are a number of proposals pending before the U.S. Senate and the U.S. House of Representatives regarding the federal income tax treatment of tuition prepayment programs.

Institution-Level Tuition Prepayment Plans

Tuition guarantee programs were first introduced at the institution level. In 1985, Duquesne University, Pittsburgh, offered alumni and others the opportunity to pay current market prices for future guaranteed tuition. Three years and 622 participants later, Duquesne officials suspended the plan, citing unfavorable economic conditions. Most other institutions with prepayment plans also have dropped such programs.

For example, on June 30, 1991, Indiana University stopped the sale of guaranteed tuition certificates. This program allowed investors, typically IU alumni, to purchase future tuition hours at current rates for a 7% administrative fee. After an initial purchase of 7 credit hours, investors had the option to buy additional hours in increments of 3 or 7 credit hours. From December 1988 through June 1991, IU sold 753 investors 39,000 credit hours at $2.8 million. Because of low sales, the program did not pay its own way as anticipated, so sales were suspended. The program cost IU about $560,000—$280,000 in start-up and operating costs in the first year and about $140,000 in operating costs in each of the two following years.

The Indiana University tuition certificates already sold are still valid, but due to a flat-rate tuition policy adopted by the University's Bloomington campus in 1991, some parents who thought they had prepaid their children's tuition in full may find they owe additional tuition. The new flat-rate policy mandates that all full-time students pay for 15 credit hours per semester; those who bought certificates for 12 to 14 hours will have to pay the difference at current rates in order to use the certificates.

Elsewhere, the Phillips Academy in Andover, Massachusetts, is believed to be the first private secondary school to offer a guaranteed tuition prepayment plan. Parents can choose from two plans: They can prepay up to 4 years of tuition in a lump sum that is equal to the first year's tuition multiplied by the number of years, or, through an arrangement with the Philadelphia National Bank, they can prepay up to 4 years with a loan that can be repaid in monthly payments for up to 14 years.

Private-Sector Tuition Prepayment Programs

The first nationwide tuition prepayment program, operated by the College Prepayment Fund, Inc. (CPF), of Bethesda, Maryland, became operational in October 1989. CPF has contracted with the National Bank of Detroit to collect prepayments from parents and to disburse the funds to participating colleges when the beneficiaries matriculate. Parents can

[4]The Florida program has had a cancellation rate of about 8%. The total number of active contracts at the end of year three is 127,383, which represents 99,316 tuition contracts and 28,067 dormitory contracts.

choose to prepay a portion of a year or any number of years at any participating institution. Families that earn over $25,000 per year must make an initial payment of at least $1,000; families that earn less than $25,000 can prepay any amount over $100.

Parents will be taxed annually on the interest earnings, but are allowed to withdraw their principal and interest earnings at any time without penalty. To date, fewer than 20 colleges and 100 participants have signed on to the program, and, like the Indiana University plan, CPF has been put on hold.

In an attempt to capture the advantages of both savings and guaranteed tuition programs, some sponsors have created plans that combine the two.

While private-sector plans can enable parents to choose among colleges across the nation, participants are gambling on the colleges themselves. Small private colleges and universities may be substantially different 15 or 20 years after the tuition is purchased. Further, the colleges themselves are gambling. If they underestimate future tuition, they will be liable for the shortfall between what parents prepaid and the cost of tuition.[5] Indeed, Anderson (1991) notes that colleges have overwhelmingly rejected these private programs, opting for parents to assume both the risks and rewards of precollege savings.

[5]CPF Treasurer Harold Munn, Jr., discounts these liability risks, noting that students who enter college with their tuition bills already paid will save the institutions considerable sums that would otherwise have been spent on financial aid.

College Savings Plans[6]

Public-sector college savings plans primarily utilize state and city college savings bonds and federal EE Series savings bonds. These programs are described below.

College Savings Bonds

College savings bonds are safe, conservative investments. The bonds are typically zero coupon, tax exempt, and state-backed. Most college savings bonds may be used for noncollege expenses, but many have built-in incentives when used specifically for college. Some states provide an additional bonus if the bonds are used at institutions within the state, but these bonuses are taxable. Some potential limitations are that these bonds have not proven to be effective savings mechanisms for families that are not already saving for college and that bond performance is questionable during periods of high inflation. Further, the bonds are not always available when savers want them. Some states have offered a college savings bond issue only once or infrequently.

Anderson (1989) describes three problems with tax-exempt bonds for college savings. First, an inherent conflict of interest exists between the state's goal in issuing tax-exempt debt (to finance state projects as inexpensively as possible) and the appropriate policy goal of family financing of higher education (to help families earn the highest rate of return). Second, tax-exempt bonds are designed for financing rather than saving, and although well suited for some (e.g., high-tax-bracket families), they may be ineffective for others (e.g., low-tax-bracket families). Third, the historic rate of return for tax-exempt bonds is modest at best, and to be effective the bonds must keep up with college costs, which can easily outpace inflation by about 2% to 2.5%.

Another concern with savings bonds is equity. Low-income families generally do not have sufficient discretionary income to save for higher education. Wisconsin's college savings bond program came under attack during its first few years of operation for claiming to be designed for low-income families when the majority of bonds appear to have been sold to affluent families. Most of the bonds were sold through brokerage houses rather than community banks, 46% of the bonds were sold in increments over $5,000, and at least 21 people purchased more than $50,000 worth of bonds (Blumenstyk, 1990).

About half of the states currently issue college savings bonds. Chicago may have become the first city to offer college savings bonds. The Pittsburgh public school system has recently issued $13 million in college savings bonds. This is believed to be the first sale of its kind by a school district.

Federal EE Savings Bonds

Series EE Bonds are part of the regular federal savings bond program. These bonds may be purchased in increments as low as $25 and are redeemable at any time. They differ from other bonds in that EE Bonds purchased after December 31, 1989, and used for the education of oneself, one's spouse, or one's children may be redeemed without having to pay federal, state, or local income taxes on interest realized at redemption. Series EE bonds cannot be distinguished from regular savings bonds prior to redemption, and then only the IRS will be informed of the

[6]Private-sector savings plans utilize stocks, bonds, securities, life insurance, annuities, and other financial instruments and may be used for college or any other purpose. These plans vary greatly and are beyond the purview of this paper.

bond's use. Investors must be over 23 years of age, and the tax exemption is phased out for joint filers earning between $60,000 and $90,000. Unfortunately, the income restrictions are enforced when the bond is redeemed, not when it is purchased. This puts savers in the difficult position of not knowing whether or not they will be eligible for the tax exemption at the time when the bonds are needed for college.

Combination Guarantee and Savings Plans

In an attempt to capture the advantages of both savings and guarantee tuition programs, some sponsors have created plans that combine the two. The Massachusetts College Opportunity Fund and the College Sure CD provide good examples.

The Massachusetts Plan

The Massachusetts College Opportunity Fund was signed into law by Governor Michael Dukakis in January 1990. However, the state agency responsible for the program, the Massachusetts Educational Financing Authority, has been unable to secure $450,000 in needed start-up funds from the private sector. Under this plan, parents would be able to purchase tax-exempt bonds in small denominations (as low as $50) that represent tuition shares at participating universities. These tuition shares would be indexed to the annual increase in national tuition costs. The "share" concept works as follows: If an institution is charging $10,000 for tuition at the time a $1,000 share is purchased, that institution will guarantee that the bond will purchase 10% of the tuition cost at the time the student matriculates even if bond proceeds fail to cover tuition increases. If the participating institution's tuition increases more than the national average, the school will offer tuition discounts to bond-holding students. In theory, this feature could help colleges keep their tuition increases down. If the bonds were used to pay for noneducational expenses or used at nonparticipating schools, the interest rate would be lower than the rate based on tuition increases, but it is unknown just how low that would be.

The advantages of this plan are that families are guaranteed a certain percentage of college tuition, there are no age or income limitations for investors, the bonds are transferable to immediate family members, there are no mandatory lump-sum contributions, and investors can change their plans (including using the money for noncollege expenses) without substantial penalty.

Prior to implementing these programs, policymakers must determine if state and institutional risks are justified.

Disadvantages include program complexity and restrictions on college choice to participating institutions within the state. Also, instead of keeping college tuition down, the program might create perverse incentives for raising tuition costs to make up for lost revenues if investment income falls short of tuition increases. Indeed, a family that purchases a certain percentage of its tuition bill may find the rest of the bill has been increased to pay for such a service (Hauptman, 1990).

The College Sure CD and College Sure Plus CD

The College Sure CD and College Sure Plus CD were developed by the College Savings Bank of Princeton, New Jersey, and are variable-rate certificates of deposit (CDs) linked to the Independent College 500 Index, which represents the average price changes at 500 independent four-year institutions. By linking the variable rate to this index, investors hope to keep up with the rising costs of college.

Disadvantages exist with this plan as well. First, the rate of return is the college inflation rate minus the premium charges by the bank—1.5% for the College Sure CD and 1% for the College Sure Plus CD. Further, the guaranteed rate of return is based on pre-tax dollars. With the premium paid to the bank and the tax on the accretion, this kind of investment might not be in the best interest of all families. In addition, college cost increases at private colleges (which make up the Independent 500 College Index) are not necessarily identical to increases at public institutions.

Implications

College tuition prepayment and savings plans can increase a family's resources in financing postsecondary education and may reduce the need for more expensive forms of student aid. Yet, as the table on the next page illustrates, no single plan is without drawbacks. Further, these plans are not appropriate for all families and provide little benefit to the most financially disadvantaged.

When considering any plan for financing college education, public policymakers face tough choices. Desirable components for parents (e.g., exemption from taxes) often conflict with desirable components for the government. Prior to implementing these programs, policymakers must determine if state and institutional risks are justified. Expenditures for start-up and administration should be kept as low as possible, and state liability should be minimized. The program should not influence tuition rates, and the plan should generate new savings rather than simply displace existing

COMPARISON OF PREPAYMENT AND SAVINGS PLANS

	Institution Investment Income	*Tuition Guarantee*	*Tax-free Returns*	*Parental Security*	*State Security*	*Institution Security*	*Student Choice*
State Tuition Prepayment*	NO	YES	YES (state only)	YES	NO	YES	YES (limited)
Institution Prepayment*	YES	YES (usually)	NO	YES	YES (limited)	NO	NO
Private-Sector Prepayment	NO	YES (usually)	NO	YES (limited)	YES	NO	YES (limited)
College Savings Bonds	NO	NO	YES	YES	YES	YES	YES
Federal EE Bonds	NO	NO	YES (w/restrict.)	YES	YES	YES	YES
Combination Plans (Public)*	NO	YES (partial)	YES	YES (limited)	YES (limited)	NO	YES (limited)
Combination Plans (Private)	NO	NO	NO	YES (limited)	YES	YES	YES (limited)

* It is also possible that these plans could influence future tuition costs.

savings. The plan should reach new, moderate-income groups and should be compatible with federal, state, and institutional financial aid programs.

When considering the use of tax-exempt investment vehicles, policymakers must consider two additional issues. First, the effects of foregone tax revenue are identical to new expenditures in efforts to reduce the federal budget deficit. This problem arises only when tax-exempt investments are used for expenses other than tuition, however, as tuition payments are not taxable in the first place (Hull, 1989). Second, tax-exempt savings programs create many administrative responsibilities, such as annual reporting by savings institutions and others to verify that the tax-exempt investment funds are actually deposited and withdrawn for college-related expenses (Miller, 1985).

Prior to implementing any college savings or prepayment plan, policymakers must agree upon the problem they hope to resolve. Public policy designed to increase college choice, for example, vastly differs from public policy geared to provide college access.

Clearly, no single existing state, institutional, or private prepayment or savings program is without its share of risks and rewards. Parents, planners, and policymakers need to weigh the issues discussed in this paper to determine the type of plan that best suits their needs. By studying the successes and failures of existing prepayment and savings programs, planners and policymakers can work toward making college financing easier for institutions and states and, most importantly, for students and families.

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